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No. 434

In the Supreme Court of the United States

OCTOBER TERM, 1932

THE UNITED STATES, PETITIONER

v.

DAKOTA-MONTANA OIL COMPANY

ON A WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

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OPINION BELOW

The opinion of the Court of Claims is reported in 59 F. (2d) 853. (R. 5–16.)

JURISDICTION

The judgment of the Court of Claims was entered July 5, 1932. (R. 16.) Petition for a writ of certiorari was filed October 5, 1932 (R. 16), and granted November 14, 1932 (R. 17). The jurisdiction of this Court rests upon Section 3 (b) of the Act of February 13, 1925.

QUESTION PRESENTED

Whether, under the Revenue Act of 1926, capitalized expenditures for preliminary development

and the drilling of oil wells may be added to the cost of physical property subject to a depreciation allowance, or are returnable to the taxpayer through a depletion allowance.

STATUTES AND REGULATIONS INVOLVED

The applicable statutes and regulations are contained in Appendix A (*infra*, pp. 22–29).

STATEMENT

The respondent, engaged in the production of oil during the years 1923 to 1926, spent sums on its properties in preliminary development, in drilling oil wells, and for camp buildings and equipment. (R. 5, 8.) These expenses were capitalized. (R. 6.)

The respondent duly filed its tax return for the calendar year 1926 and paid the tax reported on this return. In this return respondent claimed a deduction of $159,200.71 for depletion and $13,210.58 for depreciation on certain camp buildings and equipment. (R. 7.) Thereafter an amended return and claim for refund were duly filed, claiming a deduction for depletion of $158,169.24, which was 27½ per cent of respondent's gross income from oil operations (R. 5), and an increased deduction for depreciation in the total amount of $163,301.81, based upon depreciation "on well equipment and on intangible drilling costs," "camp buildings and lease equipment," and "on preliminary development" (R. 7). The claim for an increased

allowance for depreciation of camp buildings and equipment was allowed by the Commissioner of Internal Revenue and a refund tendered, but the other claims for depreciation were denied. (R. 7.) The Court of Claims held that respondent was entitled to deduct depreciation for drilling costs and preliminary development and gave respondent judgment for $19,096.12. (R. 14.) Two judges dissented. (R. 14–16.)

It is conceded that the respondent is entitled to a judgment of $8,420.21 because of the allowance of further depreciation upon the camp buildings and equipment. This amount is not now in issue. If the court below was correct in holding that the amounts expended for drilling costs are returnable through depreciation, the respondent is entitled to a further deduction for 1926 and an additional refund of $9,628.36. If, in addition, the early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of the oil wells are returnable through depreciation, respondent is entitled to an additional refund of $1,047.55.

SPECIFICATIONS OF ERROR

1. The Court of Claims erred in holding that capital expenditures for drilling an oil well are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

2. The Court of Claims erred in holding that capital expenditures for preliminary development

of an oil field are to be recovered through an allowance for depreciation rather than through an allowance for depletion.

3. The Court of Claims erred in giving judgment for the respondent for $19,096.12.

SUMMARY OF ARGUMENT

I

Section 234 (a) (8) of the Revenue Act of 1926 provides for a reasonable allowance "for depletion and for depreciation of improvements" in the case of oil and gas wells, the allowance in all cases to be made under rules and regulations prescribed by the Commissioner of Internal Revenue. Pursuant to the authority so conferred, regulations were promulgated which distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development which do not result in any tangible physical property. Expenditures of the latter class, if capitalized, are returnable only through a depletion allowance. The distinction made in the regulations between the two types of expenditures is based upon the nature of oil wells and the practices of the industry. Under the regulations, expenses for drilling wells are not regarded as resulting in physical property. The facilities provided by such expenditures have no useful life apart from the mineral reserve. It is logical that the return of such expenditures, if capitalized, should be through

depletion only. The regulations have a reasonable basis. Since the respondent exercised the option afforded by the regulations, it is bound thereby.

Not only were the regulations explicitly authorized by statute, but they have received implied legislative approval.

In view of the regulations, there is no basis for the argument that the depletion allowance under the statute is limited to an allowance for depletion of the oil reserve only, nor is there any basis for the argument that return of expenses for drilling through depletion allowance would not result in complete recovery of cost of drilling and cost of the oil reserve. Section 204 (c) provides explicitly that the arbitrary allowance of 27½ per cent shall not be less than the allowance would otherwise be, so that the taxpayer would be entitled to a larger depletion allowance if the arbitrary allowance were insufficient to return cost.

II

The preliminary expenses incident to the leases and preliminary to drilling, construction, and completion of oil wells are not subject to a depreciation allowance. So far as the record discloses their nature, they are clearly not expenses which represent property worn out with use, and in so far as their nature is not disclosed by the record there is nothing to indicate that the Commissioner's action in denying depreciation thereon was erroneous.

ARGUMENT

I

RESPONDENT'S EXPENDITURES FOR DRILLING OIL WELLS, HAVING BEEN CAPITALIZED, WERE RETURNABLE ONLY THROUGH A DEPLETION ALLOWANCE, AND THE RESPONDENT WAS NOT ENTITLED TO ADD THEM TO THE COST OF PHYSICAL PROPERTY SUBJECT TO DEPRECIATION

The court below sustained the respondent's claim that under Section 234 (a) (8) of the Revenue Act of 1926 it was entitled to add capitalized expenditures made for drilling oil wells to the cost of physical property subject to depreciation. Respondent's claim is for an allowance of depreciation upon such expenditures, in addition to the allowance of 27½ per cent of its gross income from oil-well operations for the taxable year which it has claimed and received as a depletion allowance. We contend that under the Revenue Act of 1926 and applicable valid regulations the respondent was entitled to have such capitalized expenditures returned only through the depletion allowance and that the decision of the court below allowing their return as depreciation was erroneous.

Section 234 (a) of the Revenue Act of 1926 (*infra*, p. 22) provides that in computing the net income of a corporate taxpayer certain deductions shall be allowed. The subdivision involved here is—

> (8) In the case of mines, oil and gas wells, other natural deposits, and timber, a rea-

> sonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. * * *

The basis for the allowance for depletion in connection with oil and gas wells is specified in Section 204 (c) (2) (*infra*, p. 22) as follows:

> In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Pursuant to the express authority conferred by Section 234 (a) (8), regulations were promulgated which provide in detail for the allowance of depletion and depreciation in connection with oil and gas wells. Regulations 69, Art. 223 (*infra*, p. 23), provides in part:

> Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a

> development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. * * * An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. * * *

Specific provision for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., is made in Regulations 69, Art. 225 (*infra*, p. 24). In 1932, Art. 223 of Regulations 69, its predecessors, and its successor under the Revenue Act of 1928, were restated by the Commissioner, with the approval of the Acting Secretary of the Treasury, to incorporate therein details of administrative application and practice of long standing without involving any change in administrative policy or practice. T. D. 4333 (*infra*, p. 25).

The articles of the regulations referred to above distinguish between expenditures for physical property subject to depreciation and expenses incurred in exploration, drilling, and development not resulting in any tangible physical property apart from the land. Expenditures of the latter class may, at the option of the taxpayer, be deducted as current expenses or be capitalized. If capitalized they are to be returned solely through a depletion allowance.

The basis for this distinction may be found in the peculiar nature of oil wells and the practices of the oil industry.[1] Analysis of the regulations in the light of the subject matter with which they deal shows that the distinction so made is clear and that it rests upon a reasonable basis. The type of "physical property" dealt with in Art. 223 is indicated by the specific reference to certain property in Art. 225. The property so mentioned is of a character which has an independent measurable service life depending on its own inherent qualities and the extent to which the property is subjected to use in connection with the enterprise. These factors determine the rate at which such property is consumed. The amount of annual depreciation of such property is readily ascertainable under familiar principles and by the usual methods for determining allowances for depreciation of property used up in the course of a business. Where expenses like those for wages, transportation, etc., are incurred in the process of providing such physical property so that they would normally be recognized as constituting a part of the cost of such property, they may be readily included in the cost and thus in the allowance for depreciation as the property is worn out.

[1] A study of the basis for the classification, prepared by Elden McFarland, Esq., Special Attorney in the Office of the General Counsel of the Bureau of Internal Revenue, in conjunction with the engineers of the Bureau, is printed as Appendix B (*infra*, pp. 36–37). It was printed as an appendix to the Government's brief in the court below.

On the other hand, expenditures in exploring for minerals (such, for example, as expenditures for surveying, geological work, etc.), for development (such, for example, as clearing the ground, draining, road making, grading, stripping, etc.), including the drilling of a hole for the casing so that oil may eventually be extracted, and the digging of shafts, tunnels, slopes, etc., in the case of a coal mine (see Art. 222, Reg. 69), do not result in any article of property apart from the land or susceptible of depreciation. They are identical in purpose and result with the operation of stripping the overburden from an open-pit iron-ore mine to make the mineral available for extraction; and it is obvious that "depreciation" can not be applied to the object of such an expenditure. The result of expenditures of this class is not to create a new item of property; its direct and its only result is to augment the value of the existing mineral reserve. While such expenditures may result in changes in the conformation of the land and are necessary to provide access to the oil supply in order to permit its eventual extraction, there is no gradual wearing out of such facilities. Since they have no further utility in the enterprise after all of the oil has been extracted, the conclusion of extraction and their consequent abandonment fixes the time when their usefulness ends. Thus, the facilities resulting from such expenditures are closely associated with and their useful life can be measured accu-

rately only by the mineral reserves. It would ordinarily be quite impossible to apply to them any of the usual methods of determining depreciation. By providing for return of these costs through depletion, if the taxpayer elects to capitalize them, the regulations realistically recognize that they should be considered as a part of the value of the mineral reserve, upon the exhaustion of which their usefulness depends. The logic of the regulations in treating such expenditures, if capitalized, as returnable only through depletion is recognized in *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273 (C. C. A. 4th), now pending on certiorari, *Petroleum Exploration* v. *Burnet*, No. 448, October Term, 1932.

The restatement of Art. 223 of Regulations 69 (*infra*, p. 25), which contains an exposition of the administrative application of this and similar articles under various regulations, clearly shows the distinction between expenses which are represented by tangible property and those which are not. Expenses for drilling wells are described as "intangible" drilling and development costs which the taxpayer may, at its option, charge to capital or expense. Such expenditures are considered as not represented by physical property. If the taxpayer, in the exercise of this option, capitalizes the cost of drilling, such expenditure is returned through the depletion allowance. The restatement further describes the expenditures which are represented by physical property, and are thus return-

able through depreciation under the applicable regulations. The distinction made by Art. 223 between capitalized expenses which are represented by physical property, and those which are not, has been consistently maintained in practice, and it is entirely clear that the administrative officers have considered that expenses for drilling oil wells, if capitalized, can, under the regulations, be returned only through a depletion allowance.

The respondent exercised the option provided by Art. 223 of Regulations 69 and elected to capitalize the expenses for drilling oil wells. Since under the regulations such expenses are not considered as represented by physical property, the effect of the exercise of the option was to provide for return of such expenses only through a depletion allowance. In *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273, *supra*, the court held under similar facts that if the option to capitalize such expenses was exercised by the taxpayer, returned thereof could only be obtained through a depletion allowance.

In view of the inherent nature of the product of such expenses, the anomaly which would result from treating them as depreciable (since the facilities which they create are not subject to be worn out through use), and the very clear practical reasons for treating them as returnable through depletion, we believe that the distinction made by the regulations is reasonable. The distinction thus plainly made in the regulations and consistently

recognized in their application is not to be destroyed by abstract definitions. The fact that the hole in the ground which is created when an oil well is drilled may be considered as having physical qualities does not affect the application of the regulations in this case. The expenditures for drilling the hole are not treated by the regulations as represented by physical property, and as there is a reasonable basis for this rule, which has been consistently recognized in practice, the regulations are not to be stretched to permit a deduction for depreciation in connection with such expenditures, which neither the letter nor the theory of the regulations authorizes.

The regulations were promulgated under express authority of Section 234 (a) of the Revenue Act of 1926. Allowances of deductions for both depletion and depreciation are to be made "in all cases" under rules and regulations prescribed by the Commissioner. The only restriction is that the allowances thus given be reasonable. *Murphy Oil Co.* v. *Burnet*, decided December 5, 1932, No. 80, October Term, 1932. Such regulations have the force and effect of law.

Not only are the regulations in question explicitly authorized by statute, but the distinctions contained therein have been consistently applied for many years, and the regulations have, therefore, the sanction of implied legislative approval. Since the Revenue Act of 1918, which in Section 234 (a)

(9) first provided separately for depreciation of improvements in the case of oil and gas wells in addition to the provision allowing deductions for "exhaustion, wear, and tear" generally, the distinction now contained in the regulations has been maintained.[2] The provisions in the several Revenue Acts since that of 1918 have included depletion and depreciation of improvements in the case of oil and gas wells in the same paragraph and have consistently authorized allowance under rules and regulations promulgated by the Commissioner.[3] Although Section 204 (e) of the Revenue Act of 1926, providing that the allowance for depletion should be an arbitrary percentage of gross income from the property during the taxable year, except where such allowance was less than it would otherwise be, thus fixing its minimum but not its maximum, changed the method of computing the allowance provided by the earlier Acts, this change did not affect the provisions of Section 234 (a) (8) and its predecessors so as to require a departure from

[2] Arts. 223 and 225, Regulations 45, under the 1918 Act; Arts. 223 and 225, Regulations 62, under the 1921 Act; Arts. 225 and 227, Regulations 65, under the 1924 Act; Arts. 223 and 225, Regulations 69 (*infra*, p. 23), under the 1926 Act; Arts. 243 and 245, Regulations 74, under the 1928 Act; T. D. 4333, Internal Revenue Bulletin, Vol. XI, No. 15 (*infra*, p. 25), promulgated before the enactment of the 1932 Act.

[3] Section 234 (a) (9), Revenue Act of 1921; Section 234 (a) (8), Revenue Act of 1924; Section 234 (a) (8), Revenue Act of 1926 (*infra*, p. 22); Section 23 (l), Revenue Act of 1928; Section 23 (l), Revenue Act of 1932.

the distinction between property subject to depletion and that subject to depreciation, consistently maintained in the regulations. Section 234 (a) (8) of the Revenue Act of 1926 was reenacted as Section 23 (l) of the Revenue Acts of 1928 and 1932. Articles 243 and 245 of Regulations 74, under the Revenue Act of 1928, are in the same form as Articles 223 and 225 of Regulations 69 under the 1926 Act, and the restatement in T. D. 4333 of these articles under the various regulations which expounded the administrative practice thereunder was promulgated before the enactment of the Revenue Act of 1932.

Thus the authority of the Commissioner to regulate the allowance of depletion and depreciation in the case of oil and gas wells was not only expressly granted by Congress, but its exercise in the regulations here involved has the additional sanction of implied legislative approval. See *Murphy Oil Co.* v. *Burnet, supra*; *Interstate Commerce Commission* v. *New York, New Haven & Hartford R. Co.*, decided November 21, 1932 (No. 15, Oct. Term, 1932); *McCaughn* v. *Hershey Chocolate Co.*, 283 U. S. 488, 492; *Fawcus Machine Co.* v. *United States*, 282 U. S. 375, 378; *Brewster* v. *Gage*, 280 U. S. 327, 336. In *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, this Court referred to the delegation by Congress to the Commissioner of the function of making rules and regulations provid-

ing for the allowance of depletion in connection with oil wells, and said (pp. 307–308):

> The decision in the *Ludey* case [*United States* v. *Ludey*, 274 U. S. 295] has been adopted in later statutes as affecting sales of capital assets, but the provision for annual depletion allowance has remained substantially unchanged. This in itself is persuasive evidence that Congress has approved the executive construction embodied in the regulations.

In *Burnet* v. *Petroleum Exploration*, 61 F. (2d) 273, *supra*, where the precise question now involved was considered, the court held that under the regulations the cost of drilling an oil well was not subject to depreciation, but was, if capitalized, subject to a depletion allowance, and sustained the regulations.[4]

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[4] The first ruling that capitalized development expenditures of the kind now involved are depreciable was that of the Board of Tax Appeals in *A. T. Jergins Trust*, 22 B. T. A. 551 (March, 1931). The decision in that case was reversed by the Circuit Court of Appeals without consideration of the present question (__ F. (2d) __), and is now pending in this Court on petition for certiorari, No. 541, October Term, 1932. The Board of Tax Appeals in the *Jergins case* did not hold the applicable regulations invalid, but the decision appears to have been based primarily upon the terms of the stipulation in the case. The Board followed its decision in the *Jergins case*, without considering the question again, in *Petroleum Exploration*, 23 B. T. A. 890, reversed 61 F. (2d) 273 (C. C. A. 4th), *supra*; *Albert W. Ziegler*, 23 B. T. A. 1091; *P-M-K Petroleum Co.*, 24 B. T. A. 360; *United Oil Co.*, 25 B. T. A. 101. In *Freeman-Hampton Oil*

In its brief in opposition in the instant case the respondent contended that if the regulations did not permit it to recover intangible drilling costs through a depreciation allowance they were in conflict with the statute and hence invalid. The basis for this contention was the argument that the statute provided for depletion only in connection with the oil reserves, while all expenses in connection with the exploration and development of the property were, under the statute, returnable through depreciation. When it is considered that development costs only add to the value of the reserves, and when the theory of depletion is compared with that of depreciation, it is clear that the statute may not be so construed. While Congress undoubtedly might have limited the depletion allowance to the value of the oil reserves only, exclusive of development costs, it seems clear that the allowance for depletion is not so limited. Indeed, the terms of Section 234 (a) (8) furnish a further indication that Congress did not intend to limit the recovery through depletion to the oil reserves, for the statute refers to *mines* and oil and gas *wells*, and not to coal or iron or oil *deposits*.

The respondent also suggested in its brief in opposition that failure to allow depreciation upon the

Corp., 24 B. T. A. 319, the Board indicated that, were it not for the terms of the stipulation in that case, it might be necessary to reconsider its previous decision in the *Jergins case*.

cost of drilling oil wells would result in hardship, since the taxpayer would not recover the full cost of drilling through a depletion allowance. There seems to be no foundation for this suggestion. While Section 204 (c) (2) provides that "the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year," it also provides "that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." The court below found that the productive life of all producing oil wells in connection with which the capitalized expenditures were made was more than one year. Under the express provisions of Section 204 (c) (2) the taxpayer was entitled to a larger allowance for depletion than the arbitrary allowance of 27½ per centum if the arbitrary allowance was less than it would be under Sections 204 (c) and 234 (a) (8) without regard to Section 204 (c) (2). There is nothing in the findings to indicate that the allowance of 27½ per centum would not eventually restore the full cost or value of the oil reserve, including development and drilling costs. It seems clear under the statute that, if the arbitrary allowance were not sufficient to return such cost and the other capitalized expenditures subject to a depletion allowance under the regulations, a larger allowance for depletion was authorized. See Art. 221, Regulations 69. On the other hand, if the arbitrary allowance exceeded the depletion allowable on the basis contended for by respondent, and it were also

allowed depreciation on development costs, the respondent's investment would be twice returned to it to the extent of the excess of depletion allowed over depletion sustained.

II

THE EXPENDITURES PRELIMINARY TO DRILLING WERE RETURNABLE THROUGH DEPLETION

In addition to the expenses of drilling, the respondent claims the right to deduct depreciation on certain expenses described as "early and preliminary costs incident to the leases and preliminary to the drilling, construction, and completion of oil wells." (R. 8.) The Commissioner required the respondent to capitalize such expenditures and treated them as not subject to a depreciation allowance. The court below held, however, that they, like the drilling costs, were subject to depreciation. The expenditures as itemized in the findings of the court below consists of "expenses, depreciation on equipment, depreciation on furniture and fixtures, royalties, interest and taxes." There is nothing in the findings to indicate that any of these expenditures were represented by physical property. Accordingly, under the terms of the regulations they were, if capitalized and if made in connection with the exploration and development of oil wells, subject only to a depletion allowance. Preliminary expenses of this kind were not in-

volved in *Petroleum Exploration,* 23 B. T. A. 890, *supra,* or in *A. T. Jergins Trust* v. *Commissioner,* 22 B. T. A. 551, *supra.* Cf. *Freeman-Hampton Oil Corp.,* 24 B. T. A. 319, *supra.*

Depreciation of equipment, furniture, and fixtures clearly could not be the basis for additional depreciation. See Regulations 69, Art. 203 (a).

The circumstances under which royalties were paid do not appear in the findings. If they were returnable at all, the return could only be through depletion; depreciation can not be applied to them. See Regulations 69, Art. 216. Cf. *Murphy Oil Co.* v. *Commissioner,* decided December 5, 1932, No. 80, Oct. Term, 1932; *Burnet* v. *Harmel,* decided November 7, 1932, No. 26, Oct. Term, 1932. Whether the respondent was entitled to a depletion allowance thereon need not be determined in the instant case, since it does not appear that the allowance of 27½ per cent was inadequate and the respondent does not assert a right to obtain any further depletion allowance.

The nature of the payments for expenses, interest, and taxes does not appear, and in the absence of any showing that the Commissioner's action was erroneous it should have been sustained by the court below. As our discussion of the regulations under Point I establishes their validity, we believe that, if applicable at all to the items now involved, the regulations plainly deny any allowance upon such items for depreciation, and further discussion thereof seems unnecessary.

CONCLUSION

The judgment of the Court of Claims should be reversed, with directions to enter a judgment for the respondent in the sum of $8,420.21.

Respectfully submitted.

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JANUARY, 1933.

APPENDIX A

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1926, c. 27, 44 Stat. 9, 16, 41:

SEC. 204. (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph. (U. S. C. App., Title 26, Sec. 935.)

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence;

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depre-

ciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; (U. S. C. App., Title 26, Sec. 986.)

Treasury Regulations 69:

ART. 221. DEPLETION IN THE CASE OF OIL AND GAS WELLS.—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

ART. 223. CHARGES TO CAPITAL AND TO EXPENSE IN THE CASE OF OIL AND GAS WELLS.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so

far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells. An election once made under the provisions of this article will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompanying the return.

ART. 225. DEPRECIATION OF IMPROVEMENTS IN THE CASE OF OIL AND GAS WELLS.—Both owners and lessees operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost or other basis equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satis-

faction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation on such property may be based upon the length of life of the deposit. (See articles 161–170.)

Treasury Decision 4333, Internal Revenue Bulletin, XI, April 11, 1932, No. 15, pp. 2–3:

SECTION 23 (m).—DEDUCTIONS FROM GROSS INCOME:

BASIS FOR DEPRECIATION AND DEPLETION

Article 243: Charges to capital and to expense in the case of oil and gas wells. XI–15–5440 T. D. 4333

INCOME TAX

Charges to capital and to expense in the case of oil add gas wells—Restatement of article 223, Regulations 45; article 223, Regulations 45 (1920 edition); article 223, Regulations 62; article 225, Regulations 65; article 223, Regulations 69; and article 243, Regulations 74.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Article 223 of Regulations 45, article 223 of Regulations 45 (1920 edition), article 223 of Regulations 62, article 225 of Regulations 65, article 223 of Regulations 69, and article 243 of Regulations 74 are hereby restated so

as to incorporate therein certain details of administrative application and practice of long standing. No change in administrative policy or in the practice under the regulations is made, or intended to be made, by this restatement; nor is any new option or election as to the treatment of the expenditures involved granted or intended to be granted. The new matter appearing in the restatement represents the practice of the Bureau of Internal Revenue under the regulations since prior to the promulgation of Regulations 45, on April 16, 1919. That portion of article 223, Regulations 45; article 223, Regulations 45 (1920 edition); article 223, Regulations 62; and article 225, Regulations 65, dealing with casing-head gas contracts and the use of inventories, is not restated. The restatement follows:

Charges to capital and to expense in the case of oil and gas wells.—(a) Items chargeable to capital or to expense at taxpayer's option. (1) Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs. Examples of items to which this option applies are, all amounts paid for labor, fuel, repairs, hauling, and supplies, or any of them, which are used (A) in the drilling, shooting, and cleaning of wells; (B) in such clearing of ground, draining, road-making, surveying, and geological work as are neces-

sary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil or gas. In general, this option applies only to expenditures for those drilling and development items which in themselves do not have a salvage value. For the purpose of this option labor, fuel, repairs, hauling, supplies, etc., are not considered as having a salvage value, even though used in connection with the installation of physical property which has a salvage value. Drilling and development costs shall not be excepted from the option merely because they are incurred under a contract providing for the drilling of a well to an agreed depth, or depths, at an agreed price per foot or other unit of measurement.

(2) Option with respect to cost of nonproductive wells: In addition to the foregoing option the cost of drilling nonproductive wells may at the option of the taxpayer be deducted from gross income as an expense or charged to capital account returnable through depletion and depreciation as in the case of productive wells.

(3) Elections once made under these options will control the taxpayer's returns for all subsequent years. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

(*b*) Recovery of optional items, if capitalized. (1) Items returnable through depletion: If in exercising these options, or either of them, the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are not represented by physical property, are returnable through depletion. For the purposes of this article the expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting and cleaning of wells, are considered not to be represented by physical property, and when charged to capital account are returnable through depletion.

(2) Items returnable through depreciation: If in exercising these options the taxpayer charges such expenditures as fall within the options to capital account, the amounts so capitalized, in so far as they are represented by physical property, are returnable through depreciation. Such expenditures are, amounts paid for wages, fuel, repairs, hauling, supplies, etc., used in the installation of casing and equipment and in the construction on the property of derricks and other physical structures.

(3) In the case of capitalized intangible drilling and development costs incurred under a contract such costs shall be subject to the foregoing segregation for the purposes of determining the depletion and depreciation allowances.

(*c*) Nonoptional items distinguished. (1) Capital items: The option with respect to intangible drilling and development costs in general does not apply to expenditures by which the taxpayer acquires tangible property ordinarily considered as having a sal-

vage value. Examples of such items are the costs of the *actual materials* in those structures which are constructed in the wells and on the property, and the cost of drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, etc. The options do not apply to any expenditure for wages, fuel, repairs, hauling, supplies, etc., in connection with equipment, facilities, or structures, not incident to or necessary for the drilling of wells, such as structures for storing or treating oil or gas. These are capital items and are returnable through depreciation.

(2) Expense items: Expenditures which must be charged off as expense, regardless of the options provided by this article, are those for labor, fuel, repairs, hauling, supplies, etc., in connection with the operation of the wells and of other facilities on the property for the production of oil or gas. General overhead expense, taxes, and depreciation of drilling equipment, are not considered as capital items, even when incurred during the development of the property.

DAVID BURNET,
Commissioner of Internal Revenue.

Approved March 30, 1932.

A. A. BALLANTINE,
Acting Secretary of the Treasury.

APPENDIX B

STUDY OF BASIS OF CLASSIFICATION WITH RESPECT TO DEPLETION AND DEPRECIATION OF CAPITAL EXPENDITURES IN CONNECTION WITH OIL WELLS

(Prepared in Bureau of Internal Revenue)

The exploitation of an oil lease, from the standpoint of the producer as distinguished from the carrier, refiner, or marketer, may be divided into three general stages: (1) Exploration and preliminary development; (2) drilling and equipping wells; (3) operation.

The first may or may not be the source of major expenditures. If the operator merely makes a location on land in a settled community near an existing road and water supply, by guess instead of geological study or survey, he has practically no preliminary development costs. On the other hand, it is often necessary to make extensive geological, geophysical, and topographic surveys, construct roads, clear and drain land, provide water supplies, and construct extensive camps before actual drilling of wells begins.

In the drilling of a well heavy machinery must be transported to the site, a boiler and engine must be set up, and a derrick of wood or steel must be erected for handling the tools and casing. This must be equipped with drilling machinery. There is also a certain amount of surface excavation and other similar work before drilling begins. Where high pressures are expected it is modern practice to

construct an elaborate concrete "cellar" through which the drilling is carried on. Large supplies of fuel must be provided, and the transportation of the fuel, other supplies, casings, and equipment may be one of the important items of expenditure. Both skilled and unskilled labor are required for the actual drilling operation. The labor is expended partly in making the hole and partly in the installation of the casing and other equipment. When the hole has reached a depth of a few hundred feet at large diameter it is lined with steel casing, which is usually cemented into place at the bottom. Drilling then proceeds through this casing several hundred feet deeper, when a second casing of smaller diameter is placed inside the first, reaching from the surface to the bottom of the hole, and drilling then goes on. Often a well has several concentric casings of which only the innermost and smallest reaches to the ultimate depth.

If the well is unsuccessful there is a further use of labor, fuel, hauling, etc., in salvaging the equipment and a part of the casing. If the well is successful, a producer, there is a further use of labor in making it ready to flow or to be pumped, including the construction of flow lines and flow tanks. The construction of main pipe lines, large storage tanks, and refining and converting apparatus is not generally considered to be a part of the development work. All subsequent work on the property in connection with pumping or maintenance of wells after completion is considered to be operation and is invariably charged to expense.

In considering the foregoing from the standpoint of the present problem (Depletion and Depreciation), one becomes impressed with the thought that

both elements are present in an oil well. Thus, the outlay for geological study and survey would seem to attach directly to the location or discovery of the oil deposit itself, as distinguished from the removal of such deposit, and, therefore, seems closely allied to such deposit. There is nothing depreciable in the nature of such a cost. On the other hand, machinery, tools, equipment, pipes, etc., unquestionably partake of the nature of the depreciable items.

Where should the line be drawn?

The consideration of a practical case is pertinent.

"A" acquires an oil lease. He drills a producing well at a total cost of $100,000.00; $40,000.00 thereof is the cost of equipment, such as derrick, casing, machinery. This includes not only the original purchase price but expenses of hauling and of installation, including wages of workmen, fuel, etc.; $60,000.00 thereof is the cost of the drilling and its natural incidentals, such as hauling of drilling equipment, wages, fuel. In his property account "A" shows $40,000.00 in the various physical assets and properly subjects them to depreciation. But the $60,000.00 for the drilling of the well is of a different character. It is represented by a hole in the ground. The hole does not wear out by use, as do the tools or engines. It is not consumed by the elements as is a derrick or a house. It is not used up in the production of income. It does not diminish in value due to the passage of time as does the lease. It can not be withdrawn, inventoried, or resold, as may be done with casings. Its value lies only in relation to the mineral deposit which has been discovered, developed, and made available by it. The well is a development of the oil itself—a

part of the developed deposit. So "A" charges the $60,000.00 to "cost of oil deposit."

If "A" then sells the well to "B" for $150,000.00, "B" inventories his equipment at $40,000.00 (its cost to "A" and its actual value). How shall he record the remaining $110,000.00? We know the $60,000.00 was expended for drilling and expenses incidental thereto. It is a development of the oil deposit. So "B" charges the $110,000.00 to cost of oil deposit.

Thus there has developed a terminology peculiar to oil and gas wells—the use of the expressions tangible and intangible costs. It became necessary to designate such expenditures as related to physical assets which readily admit of depreciation and those relating to assets which do not readily lend themselves to such classification. Thus the costs, lumber, cement, casing, tubing, machinery, tools, and derricks are characterized as *tangible* costs, while geological costs, surveying, hauling, wages, and fuel were characterized as *intangible* costs.

These intangible costs were of two kinds: (1) Those relating to physical assets, and (2) those not relating to physical assets. Thus wages, fuel, and hauling in connection with the erecting of a derrick, of the placing of the casing, or the installation of machinery were of the first class and if capitalized were depreciable. But expenditures for geological surveys, hauling of surveying instruments, expenses of surveying, hauling of drilling tools, wages, fuel, and hauling connected with exploration, drilling and development connected with geological work, being of a class directly related to exploration, development, and discovery of the mineral it-

self, were more closely allied to the natural deposit than to a so-called "physical asset." Such expenditures, although incidental to the drilling of a well, often assume major proportions.

It is such expenditures with which we are concerned in the instant case—incidental expenditures for wages, fuel, hauling, etc., in connection with the exploration, drilling, and development of * * * leases, * * * not *represented by physical properties.*

The instant case is *not* concerned with wages, fuel, or hauling expenses in connection with *physical* properties, i. e., casing, derrick, machinery, etc. These costs, if capitalized, are unquestionably of a depreciable nature and have always been so regarded in administering the statute.

This case *is* concerned with expenditures for wages, fuel, and hauling expenses in connection with exploration, drilling, and development, but *not* represented by physical properties.

When the Revenue Act of 1918 was passed, Section 234 (a) (9) provided for a reasonable allowance for depletion of oil and gas *wells* and depreciation of improvements of oil and gas *wells,* "based on cost, including cost of development not otherwise deducted." The section also provided that such reasonable allowance was to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary.

The making of such regulations required the solution of several problems of statutory construction and of practical administration.

The statute permits a reasonable allowance for depletion and depreciation of improvements of oil

and gas wells, based on cost, including cost of development.

What does the statute mean when it says depletion of oil and gas *wells?* Does it mean depletion of the *well* as it actually says? Or does it mean depletion of the "mineral deposit" alone? Does "well" include "mineral deposit" or does it mean "mineral deposit" without the "well"? What does the statute mean by "depreciation of improvements"? What are the "improvements"? And when the statute says "based on cost including cost of development," does it mean that "improvements" are the same as "development," and is "cost of development" part of the basis for depletion?

And where the statute provides that *depletion* based on discovery value "shall be based upon the fair market value of the property * * *," what is the *property* upon the value of which *depletion* is to be based? Is it the *mineral deposit exclusive of the well?* Is it the *mineral deposit and well,* and *improvements* and machinery, or is it the deposit, the hole in the ground, and so much of the surface as is necessary to drill and operate?

And if the value of the well, i. e., the drill hole, is part of the basis of depletion in case of discovery, should it or should it not be part of the basis for depletion where discovery is not an element?

These and many other uncertainties are covered by the regulations in various articles, beginning with Article 201 through Article 226 of Regulations 45.

In Article 220 (a) (3) we find the following:

> The "property" which may be valued after discovery is the "well." For the purposes

> of these sections the *"well"* is the *drill hole*, the *surface* necessary for drilling and operation of the well, the *oil or gas content* of the particular sand zone or reservoir * * * in which discovery was made by drilling * * *. (Italics ours.)

Obviously the drill hole is an inseparable part of the *discovery and development* of the oil deposit. The foregoing regulation is in direct harmony with the letter as well as the intention of the statute, which provides for *depletion* of a *well*.

And if the value of the drill hole is a proper subject for depletion in case of discovery, there seems no logical reason for a distinction in the case of depletion *not* based on discovery. The cost thereof is as much an inseparable part of discovery and development of the mineral deposit itself in one case as in the other.

So, in Article 223, Regulations 45, it is provided that the cost of productive wells and nonproductive wells, costs of drilling, having been capitalized, are returnable through depletion and depreciation. Those expenditures for wages, fuel, repairs, hauling, etc., in connection with *drilling* and *development*, having been capitalized, are returnable through *depletion unless* represented by or made in connection with physical properties, in which latter case they were returnable through depreciation.

Improvements were defined in Article 225, Regulations 45, as relating to equipment, machinery, tools, pipes, etc., and this article specifically deals with depreciation of improvements.

Thus was the distinction clearly drawn between the *well* (including the drill hole, mineral deposit, and necessary surface) as being subject to deple-

tion and *physical* properties (as distinguished from development and discovery of the mineral deposit) as being subject to depreciation.

Expenditures for wages, fuel, hauling, etc., relating to a capital asset quite obviously partake of the nature of that asset and become a part of its cost.

Thus the labor on a building is just as much a part of the cost thereof as the lumber used in its construction. And the wages for labor in transporting a geologist to a prospective oil field are just as much a cost of discovery or development as the retainer of the geologist. And wages for labor in drilling a well, in so far as they relate to the drill hole, partake of the nature of the drill hole, and in so far as they relate to the placing of the casing, they form part of the cost of the casing in place.

So the provision in the regulation giving the capitalized expenditures the nature of the asset upon which they are expended is logical.

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